The Transactional Lawyer

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Drafting Indemnification Clauses

Charles Brocato, Jr.

A typical indemnification clause requires the indemnitor to "indemnify and hold the indemnitee harmless." It might also require the indemnitor to "defend" the indemnitee. While most legal authorities agree that the obligation to defend is different from the obligations to indemnify and hold harmless, many regard the promises to indemnify and hold harmless as synonymous, suggesting that either by itself would be sufficient. However, there is a subtle distinction between the duties to indemnify and hold harmless. Transactional attorneys need to be aware of this distinction because indemnity agreements, which aim to shift the burden of responsibility in potentially expensive lawsuits, can be critical in their practical application.

The difference between a duty to indemnify and a duty to defend is relatively clear. A duty to indemnify requires the indemnitor to reimburse the indemnitee for liability to a third person. The duty to defend requires the indemnitor to pay the costs of preparing and defending a lawsuit brought by a third person against the indemnitee. *Chemical Leaman Tank Lines, Inc. v. Aetna Casualty and Surety Co.*, 177 F.3d 210, 223 n.17 (3d Cir. 1999). One corollary to this is that the duty to indemnify arises only after the indemnitee's liability is ascertained, while a duty to defend exists as soon as "facts are alleged which, if proved, would give rise to the duty to indemnify." *Rockwood Insurance Co. v. Federated Capital Corp.*, 694 F. Supp. 772, 776 (D. Nev. 1988).

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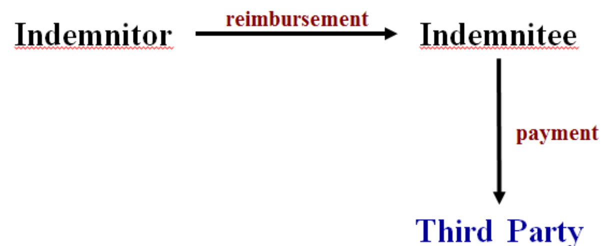
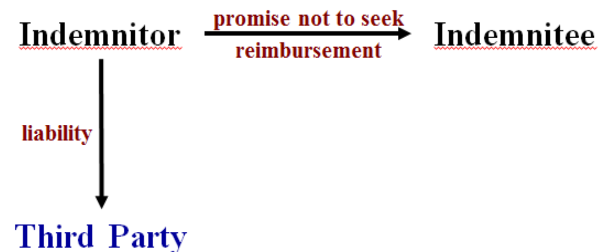
The distinction between the duties to indemnify and hold harmless is comparatively unclear, however. In fact, a number of authorities suggest that the terms are redundant and the use of both is unnecessary. *See, e.g.*, *Winchester Repeating Arms Co. v. United States*, 51 Ct. Cl. 118 (Ct. Cl. 1916); BLACK'S LAW DICTIONARY 286 (9th ed. 2009) (stating that "hold harmless" is synonymous with "indemnify"); NEGOTIATING AND DRAFTING CONTRACTUAL BOILERPLATE § 10.07[1] (Tina L. Stark, ed., 2003). However, some legal authorities have suggested that the terms carry separate, distinct meanings.

In particular, two recent decisions have indicated that a duty to *indemnify* obligates the indemnitor to reimburse the indemnitee, while a duty to *hold harmless* limits the indemnitee's liability and effectively bars the indemnitor from bringing suit against the indemnitee. Thus, in other words, indemnification deals with third party claims against the indemnitee:



In contrast, hold harmless deals with the indemnitor's claims against the indemnitee:



In the first case, *Queen Villas Homeowners Ass'n v. TCB Property Mgmt.*, 56 Cal. Rptr. 3d 528, 534 (Cal. Dist. Ct. App. 2007), a homeowners association ("the association") sought damages for a breach of contract by the property manager in charge of the association's condominiums because the property manager allegedly allowed an association board member to embezzle money from the association. The

issue in the case turned on whether the association's breach of contract action was barred by the contractual clauses in which the association promised to indemnify the property manager. The California Court of Appeals held that the action was not barred because indemnity clauses apply only when a third party brings suit. *Id*. at 533. In reaching its decision, the court distinguished a "hold harmless" clause, which would have provided the property management company with a right to exculpation. *Id*. The court decided that the right to be indemnified is "offensive," while the right to be held harmless is "defensive." *Id*.

The Delaware Court of Chancery appeared to agree with this distinction when it noted in a footnote that while the terms "indemnify" and "hold harmless," have similar meanings, "the word indemnify generally grants rights, and the phrase hold harmless generally limits liability." *See Majkowski v. American Imaging Mgmt. Services, LLC*, **913 A.2d 572**, 592 n.55 (Del. Ch. Ct. 2006). *Cf.* MELLINKOFF'S DICTIONARY OF AMERICAN LEGAL USAGE 286 (1992).

Whether an attorney should use the phrases "indemnify," "hold harmless," "duty to defend," or some combination of the three depends on whom he or she is representing and what effect he or she hopes to achieve. An attorney representing the indemnitee would be wise to use all three terms, so as to grant the client the maximum amount of protection. However, an attorney representing an indemnitor should use as few of the phrases as possible, because this may allow the client to avoid some liability.

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Towards a Better Definition of "Securitization"

Jonathan C. Lipson

Defining terms is the bread and butter of commercial finance lawyers. Even the simplest loan or security agreement often has dozens of terms defined by agreement of the parties.

In the broader legal system, however, defining terms is a more complex process. Certainly, lawmakers can by fiat declare that a word has a particular meaning, even if the legal and common understandings conflict. Most laypersons would not, for example, expect the word "purchase" to include the acquisition of a lien or a transfer by gift. Yet, commercial finance lawyers know that the definition of "purchase" under the Uniform Commercial Code includes both such transactions. UCC § 1-201(b)(29).

Some terms, however, have evaded a precise definition. A surprising and important example is the term "securitization." Although there are literally dozens of definitions of the term in statutes, rules and commentary, they tend to be vague and overbroad. This brief essay explains why we should think more carefully about what the word "securitization" actually means, what a better definition should include, and how a better definition would work in practice.

1. Why Bother?

Before offering what I hope is a better definition of securitization, I should first explain why any particular definition matters. After all, who cares if our use of the term is vague? Vagueness can have its value. In any case, securitization is a relatively new and developing phenomenon. As two prominent commentators observed twenty years ago: "There is no particular legal meaning for securitization and, like many new financial terms, it is often used to mean a variety of things." Joseph C. Shenker, Anthony Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, **69 TEX. L. REV. 1369**, 1373 (1991).

The problem, in simple terms, is that this leaves too many degrees of freedom: because securitization "can mean a variety of things" it may simply not be clear what it means. The clarity of a better definition of securitization can thus accomplish at least three things.

First, it can help regulators, lawyers and market actors understand more precisely what they are dealing with. We now know far more about securitization than we did in the early 1990s, and that knowledge suggests that some things that may look like securitizations – and fit within statutory definitions of the term – really should not be treated as such.

For example, collateralized debt obligations (CDOs) have generally been treated as if they were securitizations, and would fit into many statutory and regulatory definitions of the term. According to U.S. bank regulators, for instance, "securitization" means "the pooling and repackaging by a special purpose

entity of assets or other credit exposures that can be sold to investors." **12 CFR Part 3, Appendix A § 4(a)(14)** (visited Aug. 12, 2011).

On its own terms, this definition is vague. Securitizations do not typically (or effectively) involve just any assets: they involve the sale of a particular type of assets – payment rights. Nor does the regulation define a "credit exposure," although a bit of digging reveals that it (probably) refers to derivative contracts that a bank may hold under applicable capital adequacy rules. ***Id.* § 3 (b)(7)(A) & (B)**.

This therefore means that a CDO – which usually involves the sale not of payment rights, per se, but instead other securities or derivative rights – would satisfy the definition. Yet, as will be discussed below, CDOs probably should not be considered securitizations because they lack certain important elements of a legitimate securitization.

Second, this vagueness matters, because it has permitted the unscrupulous to create transactions that traded on the apparent legitimacy of securitizations when, in fact, the transactions were not.

Consider again CDOs: they have been associated with some of the higher-profile allegations of misconduct by financial institutions in the credit crisis, including the so-called "Magnetar trade," in which a hedge fund bet against bonds contained in CDOs it sold to investors. *See* Jesse Eisinger and Jake Bernstein, ***The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going***, ProPublica, April 9, 2010. Moreover, and perhaps more important, investigators believe that CDOs significantly accelerated the growth and collapse of the credit bubble in the mid-2000s. *See* **FINAL REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION** 224 (Jan. 2011) ("By the end of 2008 more than 90% of all tranches of CDOs had been downgraded.").

Thus, a third reason to think more seriously about what the term securitization means is that in doing so we may rehabilitate the transaction form. Securitization has been surprisingly underutilized in foreign economies, especially in Asia. *See* Jonathan Rosenthal, *A Dangerous Embrace*, THE ECONOMIST, May 14, 2011, p. 5 (discussing Indian resistance to securitization). The credit crisis, and the role securitization is perceived to have played in it, could not have helped the image of the transaction. A more careful definition of the term organized around its basic elements and its legitimate functions will help to distinguish good from bad transactions.

2. What Should a Better Definition of Securitization Include?

A more careful definition of securitization might therefore look something like this: a true securitization is "*a purchase of primary payment rights by a special purpose entity that (i) legally isolates such payment rights from a bankruptcy estate of the originator, and (ii) results, directly or indirectly, in the issuance of securities whose value is determined by the payment rights so purchased.*"

In order to understand the work performed by this definition of securitization, it helps to think about the transaction form's essential elements and functions. Securitizations appear to have three basic elements: (i) inputs, (ii) a particular structure, and (iii) outputs.

Inputs. In most securitizations, the inputs will be primary payment rights, such as those arising under mortgages, car loans, or student loans owing to the initial payee who made or brokered the loan (known generally as the "originator" of the payment right).

The key is that the payment rights are "primary." What is a primary payment right? Simply the payment obligation of the person who received the extension of credit from the originator. It is distinct from a secondary payment right, which might be found in CDOs and other synthetic transactions.

Data recently compiled by various regulators in response to the credit crisis of 2008 indicate that inputs matter in these transactions. Although mortgage-backed securitizations performed miserably (and thus arguably triggered the credit crisis), the reality is that securitizations of many other types of primary payment rights (car loan payments, student loans, equipment leases) apparently performed reasonably well, despite the downturn. *See* **REPORT TO THE CONGRESS ON RISK RETENTION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM** 8 (October 2010).

This suggests that an effective definition of securitization should pay special attention to the inputs – the assets that are securitized. Because CDOs generally do not use primary payment rights as inputs, they should not be considered securitizations, even though current statutes would define them as such.

Structure. Legal academics and other market participants and observers believe that the heart of a securitization is its legal structure, and that it must be a "true sale." *See, e.g.*, Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, **52 BUS. LAW. 159**, 161 (1996)

("defining true sale is the holy grail of the securitization market.").

Courts and commentators have struggled for many years with the so-called "true sale" question. The chief problem is that if the transaction appears to be more like a loan secured by the assets in question than a sale, then, among other things, the assets would remain part of a bankruptcy estate if the originator encountered financial trouble. This would, in turn, potentially delay payments to security holders due to the bankruptcy stay. 11 U.S.C. § 362(a). Avoiding these costs and delays was, historically, a key reason that securitization was thought be more economically efficient than traditional forms of financing.

I do not know whether it is possible to generate a dispositive list of criteria that create a bright line definition of "sale" for this purpose. But it is not necessary to do so. If we believe that usage of trade is important to defining terms in commercial finance law, then the mere fact that lawyers, rating agencies, and other market actors act as if it were important is sufficient. A bankruptcy remote, true sale of primary payment rights should thus also be part of the definition.

Outputs. Although it may seem obvious, the output of a securitization should be securities whose value is specifically tied to the primary payment rights sold by the originator. This is an important distinction from other transactions (*e.g.*, CDOs) that may have resulted in the issuance of instruments that either were not securities or, more importantly, whose value was unrelated to the any primary payment rights.

Describing securitization's elements alone, however, will not justify the foregoing definition. All transactions – from the simple purchase of a car to a complex corporate merger – have inputs, a particular structure, and an output. In addition to understanding securitization's elements, therefore, we must also understand its function, that is, why the transaction form exists at all.

Securitization is often said to serve either or both of two legitimate ends. First, it is thought to be more economically efficient than traditional financing of the originator, such as lending or issuing shares. This is because the structure of a securitization is said to assure that those who purchase the securities need not worry about the credit risk of the originator.

Second, securitization gives originators access to capital markets which they might not otherwise have. This, in turn, is thought to reduce the cost of capital or make possible financing that would not otherwise have existed. It may also produce higher returns for investors.

Traditional bank loans, by contrast, are made by . . . banks, which are fairly heavily regulated in order to protect customers' deposits. This regulation inhibits the nature and amount of risk a bank may take. Investors in the broader capital markets, who purchase securities in a securitization, are generally subject to fewer such restrictions. In theory, this means they can provide financing unavailable from traditional banks.

Securitization's legitimate function, therefore, is to create wealth more efficiently than other forms of financing that might be available to the originator, such as secured lending or issuing shares. True, there are certainly some who doubt that securitization actually creates wealth in this way. This is not the place to resolve that debate, if indeed it can be resolved. There is, however, little doubt that transactions such as CDOs, which masquerade as securitizations, appear to be far more problematic, so much so that I suggest they should not properly be understood as securitizations at all.

3. A Better Definition in Practice

The definition I offer has at least three practical implications for lawyers.

First, it should help lawyers classify transactions. A transaction that is denominated a securitization may, for example, involve a different set of processes and parties than would other financing transactions, such as a CDO. A true securitization should, for example, rely on primary payment rights from reasonably credible obligors.

This might affect practice because if we distinguish securitizations from CDOs or other transactions that appear to be securitizations, but are not, we might approach the non-securitizations differently. Given the performance of CDOs, for example, lawyers might conduct greater due diligence on the financial assets sold in one of those transactions than in a true securitization.

Second, it can help regulators and market actors identify the elements of a securitization that appear most likely to be misused – the inputs. For example, regulators may determine that "true" securitizations – transactions that approach the definition offered here – should be subject to less regulatory scrutiny than other transactions that did not perform as well. Transactions such as CDOs, by contrast, should perhaps be subject to greater regulatory scrutiny or control.

Third, the discipline involved in more fully understanding what distinguishes functional, legitimate securitizations from other transactions can help lawyers and market participants become more intelligent and productive participants in structuring and implementing these (and related) transactions. In other words, the process of thinking about what the term securitization does and should connote can, in itself, help lawyers more effectively structure and implement these and similar transactions.

Conclusion

I do not claim that the definition of securitization offered here is the last or best word on the subject. Nor do I believe that a better definition of securitization in the past would necessarily have prevented or significantly mitigated the credit crisis: the financial crisis of 2008 was caused by many failures at many levels. Vague and incomplete definitions of securitization were part, but certainly not all, of those failures. Nor do I think that the future of securitization hangs on a better definition of the term. It became a multi-trillion dollar form of financing over the past 35 years despite the lack of an especially clear definition, so definition in itself cannot determine the fate of the transaction form.

Nevertheless, it is now time to think more seriously about what the word "securitization" actually means. The work of redefining securitization is to better understand and identify this transaction form so that we can make more intelligent social, political, and market judgments about it. If we do not define it, we may not understand it. And if we do not understand it, we will continue to fall victim to those who think that they do.

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Collateralizing the Economic Value of Broadcast Licenses

Stephen L. Sepinuck

In its recent decision in *In re TerreStar Networks, Inc.*, **2011 WL 3654543** (Bankr. S.D.N.Y. 2011), the court concluded that a security interest can attach to the "economic value" of broadcast licenses. In the process, the court expressly rejected last year's decision in *In re Tracy Broadcasting Corp.*, **438 B.R. 323** (Bankr. D. Colo. 2010), and gave comfort to those who finance broadcasters. Nevertheless, lawyers who structure and document such financing transactions should beware. The decision rests on a somewhat shaky foundation, one that struggles to support transactions of substantial size, which these deals usually are.

The issue arises from the interaction of UCC Article 9, the Federal Communications Act of 1934, and **§ 552** of the Bankruptcy Code. The Federal Communications Act provides that "[n]o . . . station license, or any rights thereunder, shall be transferred, assigned, or disposed of in any manner," without the advance approval of the FCC. **47 U.S.C. § 310(d)**. The FCC has long interpreted this language as prohibiting an assignment for security purposes: that is, as prohibiting the creation of a security interest in an FCC license. However, in response to some cases on the issue, the FCC issued a clarifying order in which it concluded that a creditor could take a security interest in the proceeds of a broadcast license. The Commission explained its rationale with the following:

> If a security interest holder were to foreclose on the collateral license, by operation of law, the license could transfer hands without the prior approval of the Commission. In contrast, giving a security interest in the proceeds of the sale of a license does not raise the same concerns. . . . The creditor has no rights over the license itself, nor can it take any action under its security interest until there has been a transfer which yields proceeds subject to the security interest.

In re Cheskey, **9 FCC Rcd. 986**, 987 (1994).

Relying on this language, many lenders have taken a security interest in the future proceeds of the borrower's FCC licenses, rather than in the licenses themselves. The potential problem with this approach is that **§ 552** of the Bankruptcy Code prevents an after-acquired property clause from operating post-petition unless the post-petition property is proceeds of prepetition collateral. Thus, the argument goes, because the license itself is not and cannot be collateral, any receivable generated by a post-petition contract to sell cannot be proceeds of prepetition collateral. It is at best after-acquired property, to which no prepetition security interest can attach. This was precisely the holding of the court in *Tracy Broadcasting*.

The *TerreStar Networks* court rejected this approach, concluding that the prepetition security interest in the broadcaster's general intangibles encompassed the "economic value" of the licenses. Thus, when the licenses were sold post-petition, the receivables generated were proceeds of the economic value.

While the decision is a clear win for secured parties, lenders should continue to be careful here. The court offered no real explanation for its conclusion that a security interest in licenses' "proceeds" – something that is unquestionably permitted but potentially cut off by **§ 552** if there is no prepetition collateral – equates to a security in the licenses' "economic value," which is not cut off by **§ 552**. Nor did it explain why this "economic value" qualifies as an interest in property that can be collateralized. The court did cite to eight decisions in support, but three of those decisions did not even cite to **§ 552**, and thus really do not support this bit of alchemy. *See In re Beach Television Partners*, **38 F.3d 535** (11th Cir. 1994); *In re Thomas Communications, Inc.*, **166 B.R. 846** (S.D.W. Va. 1994); *In re PBR Communications Systems,* **172 B.R. 132** (Bankr. S.D. Fla. 1994). A fourth was a state receivership that did not implicate **§ 552**, *State Street Bank and Trust Co. v. Arrow Communications, Inc.*, **833 F. Supp. 41** (D. Mass. 1993), and a fifth dealt only with a junior lienor's standing to object, something the court concluded it had waived in the intercreditor agreement by promising not to challenge the senior lienor's interest in the "purported" collateral, *In re Ion Media Networks, Inc.*, **419 B.R. 585** (Bankr. S.D.N.Y. 2009).

The remaining three decisions do support the *TerreStar Networks* decision, each having expressly concluded that the security interest in the proceeds of a broadcast license somehow attaches when the security agreement was executed. *See MLQ Investors, L.P. v. Pacific Quadracasting*, **146 F.3d 746** (9th Cir. 1998); *Urban Communicators PCS L.P. v. Gabriel Capital, L.P.*, **394 B.R. 325** (S.D.N.Y. 2008); *In re Media Properties*, **311 B.R. 244** (Bankr. W.D. Wis. 2004). However, the analysis by these courts is not particularly sophisticated.

In its decision in *MLQ Investors,* the Ninth Circuit wrote that "we see no reason why the proceeds should not be considered 'general intangibles,' therefore subject to perfection prior to sale." **146 F.3d at 749**. But the conclusion does not follow from the premise. The mere fact that the debtor's contractual right to proceeds could potentially be classified as a general intangible says nothing about whether or when that right comes into existence. The decision in *Urban Communicators* simply followed the Ninth Circuit's lead, and thus is subject to the same criticism.

The court in *Media Properties* said something a bit more persuasive, however. It concluded that the prepetition security interest could attach to the broadcaster's right to sell the licenses (with FCC approval), and that a post-petition contract for sale was proceeds of this prepetition right. **311 B.R. at 248**. The trouble with this approach is that it has not been blessed by the FCC. To say that a security interest can attach to the broadcaster's right to sell the broadcast license is different from saying that a security interest can attach to proceeds of the license, and might be closer to the prohibited side of the dichotomy that the FCC tried to draw.

Certainly the decisions in *TerreStar Networks, MLQ Investors, Urban Communicators, and Media Properties* all rest on good policy. Broadcast licenses can be extremely expensive and broadcasters usually need financing to acquire those licenses. If lenders were prohibited from taking a position that would render them secured claimants in a bankruptcy process, such financing would likely become far more difficult to come by, more expensive, or both. Perhaps more to the point, the legitimate concerns of the FCC would not seem to be implicated if the FCC retains the authority to approve any sale.

Nevertheless, lenders and their counsel should continue to tread carefully here. Just 12 days after the *TerreStar Networks* decision, the contrary ruling in *Tracy Broadcasting* was affirmed on appeal. *In re Tracey Broadcasting Corp.*, **2011 WL 3861612** (D. Colo. 2011). Substantial risk remains that courts will render additional decisions unfavorable to secured lenders.

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Recent Cases

Secured Transactions

In re Palmdale Hills Property, LLC,
2011 WL 4435894 (9th Cir. BAP 2011)
Repurchase agreements relating to mortgage loans were true sales, not secured transactions, even though the putative buyer had an obligation to resell identical loans and the loans were unique, because the transaction documents unambiguously indicated the parties' intent was for the transaction be a true sale.

In re O & G Leasing, LLC,
2011 WL 3799984 (Bankr. S.D. Miss. 2011)
Description of collateral as "Performance Drilling Rig # 3" and four other numbered rigs was sufficient even if the exhibit providing a more complete description was not attached when the debtor signed the security agreement because the description was sufficient "to raise a red flag to a third party, so as to indicate that more investigation may be necessary to determine whether an item is subject to a security interest." In addition, the exhibit is part of the security agreement even though attached after the debtor signed it.

In re D & L Equipment Inc.,
2011 WL 3946814 (E.D. Mich. 2011)
Financing statement that described the collateral as "[e]quipment and inventory financed by The CIT Group" was effective to perfect equipment and inventory financed by Wells Fargo Equipment Finance, Inc. after it acquired the secured loan and filed an amendment changing the name of the secured party – but not the collateral description – because the filings collectively provided notice of the possibility that Wells Fargo had assumed CIT's role in the financing arrangement.

In re Borges,
2011 WL 4101096 (Bankr. D.N.M. 2011)
Although the security agreements authenticated by the debtor secured all present and future debts owed by the debtor to both the secured party and the secured party's affiliates, and therefore granted a security interest to the affiliates, because only the secured party was listed on the financing statement, the affiliates' security interests were unperfected.

Commercial Contracting

In re Steel Network, Inc.,
2011 WL 4002206 (Bankr. M.D.N.C. 2011)
Loan agreement that provided for the borrower to pay the lender's attorney's fees "in connection with the enforcement or preservation of any rights or remedies under [the loan documents]" as well as those "related to the preservation, protection or enforcement of any rights" of lender in a bankruptcy proceeding did not cover attorney's fees incurred in defending an action for tortious interference with contract filed against the lender by a shareholder of the borrower.

Rivera v. American General Financial Services, Inc.,
2011 WL 3687624 (N.M. 2011)
Arbitration clause in consumer loan contract that excepted from arbitration foreclosure and repossession actions – the only remedies the creditor was likely to need – was so substantively unconscionable that it was void without considering whether the provision was also procedurally unconscionable.

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